Journal of Accountancy

Volume 47 | Issue 4 Article 2

4-1929

Accounts of an Investment Trust (Concluded)

Herman E. Schreiber

Follow this and additional works at: https://egrove.olemiss.edu/jofa

Part of the Accounting Commons

Recommended Citation
Schreiber, Herman E. (1929) "Accounts of an Investment Trust (Concluded)," *Journal of Accountancy*: Vol. 47 : Iss. 4 , Article 2.
Available at: https://egrove.olemiss.edu/jofa/vol47/iss4/2

This Article is brought to you for free and open access by the Archival Digital Accounting Collection at eGrove. It has been accepted for inclusion in Journal of Accountancy by an authorized editor of eGrove. For more information, please contact egrove@olemiss.edu.

The Accounts of an Investment Trust

(Concluded)

By Herman E. Schreiber

VALUATION OF PORTFOLIO

The purpose of a balance-sheet is to show the true financial condition of a business at a given date.

The most important item on the asset side of the balance-sheet of an investment trust is its investment account. The question now arises whether the investment account of an investment trust should be treated as its merchandise inventory. The merchandise inventory of a trading concern, according to approved methods, must be valued at cost or market, whichever is lower. Should this principle be used in the valuation of the portfolio of the investment trust?

The two cases are very different, as is shown by the following comparison.

With respect to the inventory of a merchandising concern:

1. The trading concern buys merchandise with the expectation, in most cases, of immediately selling at least a portion of it at a price higher than cost so as to net a profit. It plans to sell as soon as possible.
2. The stock can not be sold on a moment's notice without a considerable loss. It may take years before the company succeeds in actually disposing of all of it.
3. The stock, until sold, depreciates rather than appreciates in value.
4. The stock does not pay dividends to its owners while awaiting sale on the shelves or in the warehouse.
5. The stock is kept in storage at considerable expense, in most cases.
6. It is very difficult to determine the immediate value of ordinary merchandise.

With respect to the portfolio of an investment trust:

1. The investment trust does not "deal" in securities. It does not buy with the expectation of selling immediately at a higher price.
2. Securities such as a well managed trust would hold can be converted into cash almost immediately at market price.
3. Securities which were carefully selected are more likely to appreciate than depreciate in value over a period of time.

4. Stocks and bonds usually pay dividends or interest while they are being held.
5. Securities can be deposited for safekeeping at a very nominal charge.
6. Most securities such as would be held by an investment trust have a readily ascertainable cash value.

With all these differences there appears to be no reason why the same principles should apply to the investment account on the balance-sheet of an investment trust as apply to the merchandise-inventory account on the balance-sheet of a merchandising concern.

We shall now proceed with the analysis of the investment account, bearing in mind the fact that the principles underlying merchandise-inventory valuations are not applicable to security valuations.

The balance-sheet should show values. Costs do not always show values. In fact, values are constantly fluctuating—especially in the security markets—so that ordinarily, at a balance-sheet date, a security purchased at some prior date is worth either more or less than it cost. For example, securities bought by firm A, January 3rd, cost $10,000. February 3rd, firm B bought a similar number of these securities for $15,000. February 28th the market value was $14,000. Would it be logical to show on A's balance-sheet the "value" of the portfolio as $10,000 and on B's a "value" of $14,000, by using the rule of cost or market, whichever is lower? Why is B's portfolio worth $4,000 more than A's? This is exactly what a comparison of these two balance-sheets would indicate. The valuation placed on A's statement is, indeed, conservative, but so is B's. This reasoning plainly shows that this method of valuation is defective.

Suppose we used cost as the basis for showing this asset on the balance-sheet. In fact, this appears to be the basis used by the majority of investment trusts studied. In such case the "value" of these securities on A's balance-sheet would be shown as $10,000 and on B's as $15,000. The results are still more misleading, in this case, than in the application of the rule of cost or market, whichever is lower. A's securities are still "conservatively" valued; B's security values are inflated. A comparison of the balance-sheets of A and B would be impossible. Even a comparison of balance-sheets of the same company for two different periods would mean nothing.

INVENTORY AT MARKET

"It is possible to be conservative and at the same time prepare a balance-sheet which will disclose—not hide—favorable changes in market values." (R. H. Montgomery, *Auditing Theory and Practice,* 4th edition, page 190.) Not only favorable changes but unfavorable changes, as well, should be clearly reflected on the balance-sheet. The way to disclose the true facts is to show on the balance-sheet actual, present, market price. Such price at any given date will be the same for all balance-sheets as of that date. Book figures should show cost. At the end of each fiscal period an adjusting entry may be made, to bring such figures up to market value, by opening two special general ledger accounts for the purpose of preparing the balance-sheet:

Appreciation of securities owned....................	$4,000	
Surplus—market appreciation on securities owned....		$4,000

This entry should be reversed after closing the ledger. The debit item will be added to the book inventory, which is carried at cost. The credit item should be shown as a separate item in the surplus section of the balance-sheet and it should be plainly indicated that this item represents the amount of appreciation contained in the amount shown in the assets as investment securities.

This method makes a full disclosure of all facts, which is a test of good accounting practice. No hidden reserve is created to mislead the stockholders or the public. It is conservative in that the largest asset item—investment securities—is stated at its cash value. The unrealized profits are not merged with earned surplus and so are not made available for cash dividends.

In case the company should have the misfortune of getting caught in a severe downward trend of prices at the time of the balance-sheet, so that its portfolio had a total market value of less than its total cost, the adjustment would have to be made as follows:

Surplus—market depreciation on securities owned......	$4,000	
Depreciation on securities owned..................		$4,000

The debit item would be treated on the balance-sheet as a deduction from surplus. The credit would be deducted from the securities account so that the market value only would be shown on the balance-sheet.

Some accountants might suggest that this amount (depreciation) should be charged to profit and loss. If this were done it would necessitate the adjustment of all security accounts in the securities ledger so that they would tie in with the controlling account. This would be a useless task, as most of these securities, if they were wisely chosen, would again recover upon the return of a normal or a bull market. Furthermore, no profit nor loss could result until title to the security had been transferred.

TREATMENT OF PROFITS AND LOSSES RESULTING FROM CHANGING INVESTMENTS

British investment trusts follow one of two methods of disposing of the profits arising from changing investments. One method is to credit a reserve account for the amount of the profit so realized, charging profit and loss at the same time so that the net income will not include such profits. The other method is to credit such profit against cost of raising new capital. The balance of the profit not so applied is credited to the investment account, thereby reducing the apparent cost, or value, of investment holdings.

By the use of either of the above methods the profits on turnover of investments are not reflected by the profit-and-loss statement. An "inner" reserve is thereby created—the amount of which is not known to the public. The payment of taxes on such gains is avoided, as they need not be reported as income by investment trusts if they are not made available for dividend purposes. (As will be explained later, this is not true in the United States.)

Banks have been known to write off depreciation on securities held, crediting such depreciation directly to the investment account. This is poor policy as shown by the following illustration:

A security was purchased for $1,000; over a period of four years depreciation amounting to $200 was written off. The security was then sold for $950. The books showed a gain of $150 which was attributed to the skilful handling of investments by the officers, whereas actually a loss of $50 was sustained due to unskilful investment operations.

Some investment trusts have adopted the method of debiting the investment account for the cost of the securities purchased and crediting this account for the proceeds of the sale of invest-

ment securities. The fallacy of such a procedure can be readily seen from the following illustrations:

Securities were purchased for $50,000; later half of these were sold for $30,000. This resulted in reducing the book value of the remaining securities to $20,000. A secret reserve for $5,000 was thereby created. An actual profit was made, of which the stockholder or shareholder should have notice. It was real income which must be reported according to the federal income-tax law. On the other hand, had these same securities been sold for $20,000 the remaining securities would stand on the books at $30,000, showing a value of $5,000 over cost or $10,000 over market value.

Whenever a sale is made a profit or a loss results, unless the purchase price and the sale price are exactly the same. Such gain or loss should be reflected on the books of the trust, if the bookkeeping records are to serve their purpose fully.

Another problem arises when securities of the same kind are purchased at varying prices, and some of these are sold. For what amount shall we credit the investment account? Three answers have been given, or at least three methods of handling the situation have been put into practice: First, credit the investment account with the selling price; second, credit it with the average cost; and third, apply the sale, at the cost price, to the earliest purchases, unless definite application can be made against the identical securities purchased.

The following example will be used to illustrate these three methods:

Transactions affecting the A. B. C. Company, common-stock account

Jan. 5, 1927	Bought	100	shares at	100
July 6, 1927	"	50	" "	88
Nov. 1, 1927	"	200	" "	110
Jan. 3, 1928	Sold	50	" "	112
	These were bought Nov. 1, 1927 at 110			
Jan. 6, 1928	Sold	100	shares at	115
	These were bought Jan. 5, 1927 at 100			

Show balance of the account January 6, 1928, after the sale made on that date.

Illustration of first method

A. B. C. Company, common stock

1927			1928		
Jan. 5	Cost of 100 shares at 100........	$10,000	Jan. 3	Sold 50 sh. bought Nov. 1 at 112...	$5,600
July 6	Cost of 50 shares at 88.........	4,400	Jan. 6	Sold 100 sh. bought Jan. 5 at 115...	11,500
Nov. 1	Cost of 200 shares at 110........	22,000	Jan. 6	Balance.........	19,300
		$36,400			$36,400

No profit is reflected by the books. As an actual profit has been made, it must be reported for income-tax purposes. To complete these figures it would be necessary to keep a separate record of such transactions to obtain, at the end of the fiscal period, the correct amount of income.

Illustration of second method
A. B. C. Company, common stock

1927			1928		
Jan. 5	100 sh.	$10,000	Jan. 3	50 sh. at 104	$5,200
July 6	50 sh.	4,400	Jan. 6	100 sh. at 104	10,400
Nov. 1	200 sh.	22,000	Jan. 6	Balance	20,800
		$36,400			$36,400

This method conforms with the opinion of Montgomery, who says, in his *1927 Income-tax Procedure*, "When different purchases of the same issue of stock are made the actual result is an average cost." But he continues by saying, "There are difficulties in the application of the average rule when the certificates for the shares can be identified because there may be an actual intention on the part of the taxpayer to separate the transactions." It seems, though, that in fact it makes no difference whether it is the intention of the stockholder to sell from his first purchase or from any other, because the shares remaining after the sale, regardless of which ones they may be, have the same value as the ones sold. In the example given above the value of the 300 shares remaining immediately after the sale of 50 shares on January 3, 1928, was $33,600 (300 at 112). It would have made no difference whether the 50 shares sold had been bought July 6, 1927, at 88 or November 1, 1927, at 110; all these shares on January 3, 1928, were worth, at market, $112 each.

The gain of $1,500 has been credited to profit and loss.

The average cost of $104 used to write down the investment account at the time of sale is obtained by dividing the balance of the account by the balance of the number of shares immediately prior to the sale.

To show the application of this method where sales and purchases are made alternately the following example is given:

Date	No. of shares			Price	Average	Amount		
1927	Bought	Sold	Bal.		cost	Bought	Sold	Balance
1/3	100		100	100	100	10,000		10,000
2/5		50	50	110	100		5,000	5,000
7/6	50		100	88		4,400		9,400
8/1		50	50	114	94		4,700	4,700
11/1	200		250	110		22,000		26,700
11/9		50	200	115	106.80		5,340	21,360
12/30.		200		116	106.80		21,360	

Illustration of third method

A. B. C. Company, common stock

1927			1928		
Jan. 5	100 sh.	$10,000	Jan. 3	50 sh. at 110.	$ 5,500
July 6	50 sh.	4,400	Jan. 6	100 sh. at 100.	10,000
Nov. 1	200 sh.	22,000	Jan. 6	Balance	20,900
		$36,400			$36,400

The gain of $1,600 has been credited to profit and loss.

In this example we find that a total of 350 shares was purchased during 1927 for $36,400. Therefore the cost per share—the entire group being taken as a unit—was $104. There remained on hand of these shares on January 6, 1928, a total of 200 shares. At $104 these would show a total cost of $20,800. Only the second method shows this result in the account itself.

DISTRIBUTION OF PROFITS

It has been the policy of successful British investment trusts to be very conservative in the distribution of profits. Forty per cent., or even more, of the net earnings, above the amount required to pay bond interest and preferred dividends, is ploughed back to increase the earning surplus. It must be remembered that "net income" as used by these British investment trusts does not include profits resulting from the changing of investments. However, as such profits are used to meet the expense of new issues and in writing off discount on debentures sold, the operating costs and other deductions from income are reduced, which in turn serves to increase the net income.

It is not possible to make any general statement as to the proportion of net income distributed to stockholders in American investment trusts, first, because of the fact that they are not uniform in this particular; second, because most trusts have been so recently organized that they are still in an experimental stage, and, third, because so few of the existing trusts have made public their statements of income. Some allow all income to accumulate as surplus. Such provisions are made by the Investment Managers Company (Investment Trust Fund B). On the other hand, some of the fixed trusts pay out all income from all sources, after all expenses have been deducted. The general tendency of the conservative trusts has been to pay out only a portion of the net income to stockholders, as has been the practice of the British companies.

RESERVES

Visible reserves are created by actual book entries, while secret reserves are created by the omission of certain book entries, the charging of asset items to expense accounts, or the crediting of profits to assets.

As mentioned on a previous page, it has been the practice of British trusts to credit to the investment account gains arising from the changing of investments. As a result of using such gains to write down the investment account the true market value of the portfolio will be considerably more than its book value. The difference between the book value and the market value is a secret reserve. This method of accounting is possible in Great Britain because such gains, not being made available for dividends, are not subject to tax. This is not the case in this country. Income tax must be paid on all income whether it is set aside for dividend purposes or not. Whenever a security has been sold at a price above the cost the difference is a gain and must be reported as income for tax purposes.

When all gains and their sources are reflected upon the books a clearer conception of the ability of the management and of the progress of the trust can be had. The books will also give all the information necessary for the preparation of the company's income-tax report.

The International Securities Corporation, on its balance-sheet for November 30, 1927, shows reserves set up to secure bond interest and preferred-stock dividends. It also states that the investment securities are shown at cost less an investment reserve—the amount of which is not given. The effect of this method of treating the reserve on the balance-sheet is similar to a secret reserve, so far as the public is concerned.

It is a question whether it is necessary to set up an investment reserve at all. By allowing the surplus to grow from year to year, in accordance with the extent of the cost of the portfolio, and restraining the payment of dividends on common stock a similar effect may be obtained. A reserve set up to provide against market fluctuations is nothing more than a portion of the surplus set apart into another account and called by another name.

It has been argued that a trust's portfolio represents its fixed capital and that a reserve should be set aside to provide for its depreciation. This is not true of a general management trust be-

cause its investments are not "fixed". They are continually being changed to take advantage of changing market conditions.

Although a secret reserve has its stabilizing effect, it would be just as effective if shown openly, provided it were not made available for dividends. It prevents the management from knowing the exact results of its operations and serves to fool the stockholders and the public as to the trust's true worth.

Credit, here, is due the "fixed" trusts, such as have been created by the American Trustee Share Corporation, and others, which pay out all net income to the certificate holders and also furnish them with a list of securities held by the trustee, and the number of each, making it possible to calculate the value of a certificate at any time on the basis of the market values of the shares represented by the certificate. A secret reserve, in such circumstances, will not be created.

Fluctuations in the value of the securities held are natural and must be expected. The building up of the trust's surplus will prevent curtailment of operations during periods of market depression.

The only reserve for fluctuation of market prices that need be set up is that created at the end of a fiscal period by writing up the investment account to market value, reversing the entry after it has served its purpose on the financial statements. This has already been discussed in greater detail in this article.

TREATMENT OF COST OF RAISING CAPITAL

It has been the British plan to write off the cost of raising capital against profits on turnover of securities.

The American practice has usually been to write off such costs against paid-in surplus.

It does not seem that it matters greatly how the cost-of raising capital is written off, so long as it is not carried as an asset from year to year for too long a time. At any time when the surplus—whether paid in or earned—is sufficiently large to offset the cost of raising capital it should be at once so applied.

THE ACCOUNTING SYSTEM

Chart of accounts. To provide a basis for the construction of an accounting system the chart of accounts given here has been prepared. It is sufficiently flexible so that it can be readily revised or expanded as new problems arise or as the volume of

business increases. The accounts have been arranged to facilitate the preparation of financial statements. It may not be amiss to call attention to accounts No. 102 and No. 103, as well as No. 402 and No. 403. No. 102 is an addition to the portfolio account while No. 103 is a deduction. By the use of one of these two accounts at the end of each fiscal period the portfolio account will remain unchanged in the ledger when the necessary appreciation or depreciation adjustment is made for balance-sheet purposes. The portfolio account will at all times, after all postings have been completed, show the cost of securities owned and should prove with the investment ledger. Account 402 is an addition to surplus while No. 403 is a deduction. As these accounts do not represent realized gains or losses they should be shown as accounts separate from the regular surplus account.

Should it be desired to keep separate controls for the various types of securities owned the portfolio account could be expanded; as for example, account 1011, Portfolio—bonds; account 1012, Portfolio—stocks. Accounts 500 and 600 could be likewise further divided. This would make possible the preparation of analytical statements showing the gain or loss on the various types of securities held or bought and sold. The information requested by the statistical department will determine largely the extent of such subdivision of accounts.

Chart of accounts

Real accounts

1. Assets
    - 10. Current
        - 100. Cash
        - 1001. Petty cash
        - 101. Portfolio
        - 102. Appreciation on securities owned (debit)
        - 103. Depreciation on securities owned (credit)
        - 104. Accounts receivable (individual)
        - 105. Notes receivable
        - 106. Accrued interest receivable
        - 107. Accrued dividends receivable
    - 11. Fixed
        - 110. Office furniture
        - 111. Reserve for depreciation on furniture
    - 12. Deferred charges
        - 120. Prepaid items
        - 121. Bond discount
        - 122. Organization and financing expenses
2. Liabilities
    - 20. Current
        - 204. Accounts payable (individual)
        - 205. Notes payable
        - 206. Accrued interest payable

- 207. Dividends payable
- 208. Accrued taxes
- 209. Accrued investment service fees

21. Fixed
    - 210. Bonds

3. Capital
   - 30. Capital stock
     - 300. Preferred capital stock
     - 301. Common capital stock
4. Surplus and undivided profits
   - 40. Surplus
     - 400. Earned surplus
     - 401. Paid-in surplus
     - 402. Market appreciation on securities owned (credit)
     - 403. Market depreciation on securities owned (debit)
   - 41. Surplus reserves
     - 410. Reserve for bond interest
     - 411. Reserve for preferred-stock dividends
   - 42. Profit and loss
     - 420. Profit and loss
     - 421. Undivided profits
5. Gains
   - 50. Trading
     - 500. Gains on turnover
   - 51. Income from investment securities held
     - 510. Interest on bonds held
     - 511. Income on rights sold
     - 512. Income on stock dividends sold
     - 513. Dividends on securities held
   - 52. Other income
     - 520. Interest on notes and accounts receivable
6. Losses
   - 60. Trading
     - 600. Losses on turnover
   - 61. Administrative expenses
     - 610. Directors' fees
     - 611. Statistical department costs
     - 612. Office salaries
     - 613. Stationery and other office expenses
   - 62. Management expenses
     - 620. Officers' salaries
   - 63. General expenses
     - 630. Legal costs
     - 631. Auditor's fees
     - 632. Rent
     - 633. Commissions and brokerage fees
     - 634. Taxes
   - 64. Fixed charges
     - 640. Interest on bonds payable
   - 65. Other expenses
     - 650. Interest on loans and brokerage accounts

Bookkeeping records. The accounting books required properly to record the business transactions of an investment trust are rather simple and few in number because of the fact that the types of transactions are more or less limited. Nevertheless, the planning of a system which will minimize the work of the bookkeeper, safeguard the interests of the shareholders, show most effectively the results of the operations of the trust and be an aid

to the auditor requires careful analysis of the transactions most likely to occur during the course of a year's business.

Illustration No. 1 (page 265) shows the rulings and headings for a record of securities purchased. This record is made from the bill of the broker or other company from whom the security is purchased. Each item (in the total column) is credited to the person or company to whom the bill is payable. At the end of the month the amount (cost) column is posted to the debit of the securities or portfolio account. If desired, additional columns may be added so that separate accounts may be kept in the ledger for stocks and for bonds. The total of the interest-bought column is debited to the interest-earned account, and the total of the commission column debited to the commissions-and-brokerage-fees account.

The sales record, illustration No. 2, is made from the sales slip or confirmation. The net proceeds of each transaction are charged to the purchaser or the broker through whom the securities were sold. The totals of the cost, gain-or-loss, interest-sold, tax, and commission columns are posted to the proper accounts at the end of the month.

One investment ledger card, illustration No. 3, is made out for each kind of security purchased. The information is posted from the purchases record and the sales record. The separate items to be posted from the purchases record are listed, it will be noted, in the same order on the investment ledger card as they are on the purchases record. The same is true with the order in which these similar items appear on the sales record.

The average cost price to be used in the sales section on the investment ledger card is to be obtained from the card itself as previously explained. The dividend record forms a very important part on this card, as it will be shown later this will be of considerable help to the auditor in verifying the correctness of the dividends-on-securities-held account. This card should not be removed until all dividends due are received, when the securities were sold after the dividend date.

The cash-receipts book, illustration No. 4, contains headings which are self-explanatory. It will be noted that the sum of the credits will equal the debit in each entry, which is an invaluable feature in any book of original entry.

The cash-payments book, illustration No. 5, might well be termed a cheque register, as all payments should be made by

Purchases record

Pur. No.	Date	Through or from whom bought	Name of security	Cert. or bond No.	Quantity	Par	Price	Amount (cost)	Last int. or div. date	Interest bought	Commission	Total	Account credited	L.F.	Remarks

Illustration No. 1

Sales record

Sale No.	Date	Through or to whom sold	Name of security	Cert. or bond No.	Quantity	Par	Sale price	Amount			Last div. or interest date	Interest sold	Tax	Commission	Net proceeds	Account charged	L.F.
								Sale	Cost	Gain or loss*							

Illustration No. 2

Investment ledger card

Name of issue .... Par ....
Remarks ....

Dr. Purchases						Cr. Sales						Balance		Dividend record					
															Dividend date		Dividend received		
Purchase No.	Date	Certificate or bond No.	Quantity	Price	Amount	Sales No.	Date	Certificate or bond No.	Quantity	Average cost price	Amount	Quantity	Amount	Rate	Declared	Payable	Date	Amount	C. R. Page

Illustration No. 3

Cash receipts

Date	From whom received	Account credited	L.F.	Sundry credits	Bond interest Cr.	Stock dividend Cr.	Total cash Dr.

Illustration No. 4

Cash payments

Date	Cheque No.	Payee	Account charged	L.F.	Amount	Deposits

Illustration No. 5

cheque—hence, only cheques are recorded in this book. The deposits column, being placed next to the amount of the cheque column, makes it easy for the bookkeeper in charge of this record to determine the balance in the bank at any time.

A petty-cash book, a general journal and a general ledger will be the only books required in addition to the ones illustrated. Of course, the statistical department will also have such records as it may find necessary but these need have no relation with the regular bookkeeping records.

Internal check. The extent to which the principles of internal check can be carried in an investment trust, as in most other businesses, depends upon the number of employees and officers among whom the work of handling and recording the business transactions can be most effectively distributed. For example, where there are only three persons in the office the work may be divided as follows: one may have control over the securities, a second may have charge of the cash, and the third may have control of the records.

Where there are four persons a further division of work may be made according to the following outline:

- Cashier
  - Receives cash
  - Records cash receipts
  - Records cash payments from duplicate cheques
  - Deposits all cash intact
- Accountant
  - Keeps purchases record
  - Keeps sales record
  - Posts from all books of general ledger
  - Keeps investment ledger
  - Obtains bank statement from bank and reconciles bank balance
- Secretary and treasurer
  - Writes cheques—sends duplicates to cashier
  - Approves all bills and sends them to accountant
  - Opens all incoming mail
  - Approves all sales and purchases
- Portfolio manager
  - Has charge of securities held
  - Must immediately deposit all securities, held outright, in a designated depository and secure a receipt, and must sign for all securities returned to him
  - Approves sales slips and sends them to accountant

It will be noted in the above outline that the cashier handles all cash but does not have access to ledgers, nor to the securities; that the accountant handles the ledgers and does posting and audits bank account, but does not handle either cash or securities;

that the secretary and treasurer signs all cheques but these are audited by the accountant when they are returned by the bank; and that the portfolio manager handles securities but does not handle cash, nor does he have charge of the records.

As the organization expands the principle of internal check may be gradually extended as shown by the following diagram:

3 persons	6 persons	10 persons
1. Control of securities	1. Receives securities 2. Releases securities	1. Issues orders for sale, purchase, or disposition of securities 2. Receives and deposits all securities 3. Has joint control over depositary
2. Control of cash	3. Receives cash 4. Pays cash	4. Opens mail and lists cash received 5. Records cash receipts and makes deposits 6. Signs cheques 7. Makes record of payments
3. Control of records	5. Makes records 6. Has charge of ledgers	8. Records purchases and sales 9. Posts to general ledger 10. Keeps investment ledger

Where the office routine is handled by four persons and the division of their duties is made as outlined above it will be noted that it would be rather difficult for any one individual to misappropriate either cash or securities or income from securities without collusion with the others. Only the portfolio manager has authority to give orders to buy or sell securities and these must be approved by the secretary and treasurer. As brokerage houses mail to their customers acceptance of orders these will be received by the secretary and treasurer. Therefore no securities can be ordered on the account of the trust without the knowledge of the secretary and treasurer—who himself does not have authority to give an order. When an order to buy is executed the bill is received by the secretary and treasurer, approved by him, and sent to the accountant, who makes the necessary entry in the purchases record and in the investment ledger. The secretary and treasurer will write cheques for the payment of securities only after the purchase has been recorded. Therefore, the credit entry from the purchases record on a broker's account should always precede the debit entry from the cash payments. An exception might be where a deposit is made in advance. As all duplicate cheques pass through the hands of the cashier and all canceled cheques are audited by the accountant the trust's

money can not be used, without collusion, by the secretary and treasurer.

When an order to sell is executed the notice of sale and the credit memorandum, or the cheque in payment of the proceeds, is received by the secretary and treasurer. The sales slip must be approved by the portfolio manager, who sends it to the accountant. This also calls for the delivery of the securities.

It will be noted that all four persons receive notice of the sale—the portfolio manager must make delivery of the securities, the secretary and treasurer receives notice of the sale from the broker, the cashier must deposit the cheque received in payment of the sale (unless the trust's account is merely credited), and the accountant receives the sales slip from the portfolio manager.

It should be the accountant's duty and also the duty of the portfolio manager to consult a Dow-Jones dividend list or any other official dividend indicator and make a semi-monthly list of all securities owned which should yield dividends during the following month, the rate of dividend, the date of declaration, and the date when they should be paid. Proper record should be made on the dividend record on the investment ledger cards from these lists after the two lists have been compared. Only the rate and dividend date (declared and payable) need be transferred to the cards at this time. As the dividend cheques are received, as shown by the cash receipts, they are posted to the other three columns on the investment ledger cards (date and amount received and C. R. page columns) and the lists (just mentioned) should be checked. Dividends credited to the account of the trust by brokers holding securities of the trust must find their way to the dividend account and the dividend record on the investment ledger cards through the journal. The accountant, who does not handle any cash, it will be noted, serves as a check against the possibility of the secretary and treasurer or cashier withholding any cash received as income on securities.

Auditing procedure. Investment trusts whose business is sufficient to warrant the cost retain an outside auditor throughout the year, so that a continuous audit is maintained. When such a procedure is not followed a very careful audit is required at the end of the fiscal year.

It is not the purpose of this paper to give a résumé of auditing technique and procedure in general, but rather to apply, specifically, those principles of approved auditing procedure which are

particularly applicable to the audit of the investment trust which has been kept in mind throughout this article.

The best medium by which the auditor may assemble those details of the operations of the business which will be of most value to him in the detection of errors and fraud, and in the preparation of statements which will reflect the results of the year's operations and the present financial condition of the business consists of a set of neatly prepared working papers. Information readily obtainable from books and accountants' magazines, such as the method of preparing an audit programme, the technique of arranging papers, headings, schedules and analyses, and the making of engagement memoranda, work-sheets and reports, has all been omitted here.

The audit of the cash and the portfolio accounts is the first to receive the attention of the auditor. As most of the cash transactions will be exceptionally large, a detailed audit of cash receipts and payments is advisable. As the bookkeeping system outlined in this article requires the deposit of all receipts and the payment of all amounts by cheque the reconciliation of the cash-book balance with that of the bank is greatly facilitated.

A close relation will be found between the cash account and the portfolio account. Because of the ease with which one can be changed for the other it is of utmost importance that the auditor verify both balances at the same time and be continually on the alert to detect any irregularity in the use of either cash or securities during the year: for instance, in the use of securities as collateral for loans, the withholding of cash funds from the bank for speculation, and the buying and selling of a security without recording either the purchase or the sale and withholding the profits from the transaction.

In an ordinary balance-sheet audit the verification of the balance shown by the securities account ends when such balance is found to be in agreement with the securities count. When only a few changes were made during the year, such changes should be traced in detail. Where the transactions are numerous, as in the case of a brokerage concern, a detailed audit of all transactions is out of the question. The investment trust, which we are now considering, comes between these two extremes—although there may have been many changes made during the year the number is not so great but that a detailed audit may be made. However, the listing on working papers of all sales and purchases of securities

will not be necessary when the accounting system conforms to that outlined in this paper, as all purchases are listed in the purchases record and all sales are listed in the sales record in the same detail as they would be listed on the working papers in an audit for another type of concern where they formed only an incidental item on the trial balance.

The usual procedure for the counting and verification of cash may be followed. The emphasis in this paper, as previously explained, will be placed upon the procedure to be followed in the verification of the securities and the income-from-securities accounts.

The steps to be taken in the audit of these specific accounts will be given in the form of an outline with the necessary explanation immediately following each step:

1. Prepare a schedule of all securities owned on the date of the count. The time required to count securities and verify their ownership can be greatly shortened by listing all securities that should be on hand as shown by the investment ledger and then merely checking them on this list as the count is being made. The schedule should show the certificate or bond number, the number of shares of stock, the par value per share, the amount of bonds, where deposited or held, the name of the security, and the type of security (preference, class, etc.). All these facts and the genuineness of the instruments must be observed as they are counted. A representative of the trust should be present as the securities are counted by the auditors.
2. Count securities held, checking them against the schedule as before.
3. Obtain certifications from brokers, banks, or other depositaries where securities owned by the trust are being held for safekeeping, for delivery, or for collateral.
4. Check purchase confirmations against entries in purchases record; note dates carefully. Test purchase prices against an official stock and bond price record.
5. Check brokers' sales slips against entries in sales record, carefully noting dates. Test sales prices; also test extension of amount of sale and other calculations.
6. Check postings in sales and purchases records to investment ledger. Note dates.
7. Verify footings and cross-footings in both sales and purchases records.
8. Check postings to general ledger from all books of original entry.
9. Test calculations on investment ledger cards.

10. Verify quantity balances on investment ledger cards by finding difference between the debit and credit quantity columns.
11. Check dividend record against an official dividend indicator. This is an important step as it is a means of determining whether all income from investments has been accounted for or not.
12. Check amount column against cash receipts; or take off an adding-machine tape from the amount column on the dividend record and compare the total with the total shown per bond-interest and stock-dividend accounts—which, of course, were checked against cash receipts.
13. After verifying brokers' accounts compare brokers' statements directly with investment ledger cards.

The auditing of the cash receipts and payments and the verification of the other accounts may be completed by the usual recognized auditing methods.

Financial statements. The monthly and annual financial statements, here given pro forma, are prepared with several points in view:

1. A balance-sheet, being a "screen picture of the financial position of a going business at a certain moment" (Kester, *Accounting Theory and Practice*), should show valuations and other facts according to their actual value at that time.
2. The profit-and-loss statement should show only realized gains or losses.
3. Statements should reflect the actual results of operations and show the effectiveness of the management.

It will be noted that the arrangement of the accounts on the statements follows the order of the respective accounts on the chart of accounts.

AMERICAN INVESTMENT TRUST, INC.
Balance-sheet, December 31, 1928
Assets

Current assets:		
Cash	....	
Investment securities (at market)	....	
Accounts and notes receivable	....	
Accrued interest and dividends receivable	....	....
Fixed assets:		
Furniture and fixtures	....	
Less: Reserve for depreciation	....	....
Deferred assets:		
Prepaid expenses	....	
Bond discount unamortized	....	
Organization and financing expenses	....	....
Total assets		....

Liabilities and Capital

Current liabilities:		
Accounts and notes payable..................	....	
Accrued interest, taxes, fees..................	....	....
Fixed liabilities:		
Bonds payable.............................		....
Total liabilities........................		....
Capital:		
Preferred capital stock......................	....	
Common capital stock.......................	....	....
Surplus:		
Unappropriated...........................	....	
Market appreciation on securities owned......	....	
Reserve for bond interest....................	....	
Reserve for preferred stock-dividend..........	....	
Undivided profits..........................	....	....
Total liabilities and capital..............		....

AMERICAN INVESTMENT TRUST, INC.
Income and profit-and-loss statement
for the year ended December 31, 1928

Gross income:		
Realized investment profits (net).............	....	
Interest on investments.....................	....	
Dividends on investments...................	....	
Interest on accounts, notes and bank balances..	....	
Total income.........................		....
Expenses:		
Administrative and management expenses....	....	
General expenses...........................	....	
Interest on bonds payable....................	....	
Miscellaneous expenses.....................	....	
Total expenses........................		....
Net income...........................		....
Dividends paid on preferred stock..............	....	
Dividends paid on common stock..............	....	....
Balance after dividends.....................		....
Appropriated for preferred-stock dividends.......	....	
Appropriated for bond interest.................	....	....
Balance to undivided profits and surplus......		....